

plant elements. Even under RORR, there would be no legitimate basis to expect ratepayers to underwrite and guarantee full recovery of such investments.

While the ILECs confront the (as yet unproven) possibility of revenue loss due to competition and a prescriptive requirement that they set rates at long run incremental cost, they also enjoy unprecedented opportunities to exploit their asset base and, in particular, to benefit from strategic assets that have been acquired over the past decade whose capabilities and capacities far exceed any reasonable "public service obligation" *per se*. Thus, while ILECs face the risk of stranded investment, they also confront opportunities for substantial and sustained earnings enhancement.

d. Lower risks require lower return levels.

At paragraph 265 of the NPRM, the Commission expressly addresses and invites comment on this point:

[I]f we set up a special mechanism that permitted incumbent LECs a reasonable opportunity to recover certain costs, it would be appropriate to limit to a certain prescribed rate of return the incumbent LEC earnings on the investment portion of the costs designated for recovery, or to increase the incumbent LEC's price cap sharing obligations, given the limited risk of non-recovery under such a mechanism. Alternatively, we could permit incumbent LECs to select from two recovery options — cost recovery through market-based prices to the extent they are able in a competitive market; or cost recovery through

a regulatory mechanism, with a greater sharing obligation under the price cap plan.²⁵⁴ ...

The specific choice being proposed by the Commission gives each ILEC the ability to decide whether it or its ratepayers are to bear the risks and burdens and reap the rewards and benefits of the ILEC's investment decisions. If an ILEC decides that its ratepayers should make it whole, then it is, in effect, seeking the downside protections that RORR offers. In such an event, it is entirely appropriate that the ILEC be strictly limited in its earnings enhancement opportunities. Where an ILEC elects to be made whole:

- Recovery of any claimed "stranded investment" (i.e., the "gap" between TSLRIC and embedded cost) should be accomplished via an amortization of that amount over a fixed period of years, with no return to be earned thereon other than reimbursement for the ILEC's cost of capital.
- Rates for all ILEC services — competitive and noncompetitive — should be set at TSLRIC adjusted by a uniform surcharge to recover the annual amount of the amortization of "stranded investment." For competitive services, the price floor should be set at TSLRIC plus the surcharge.
- All revenues derived from services furnished out of its common base of assets and organizational resources, whether "basic" or "enhanced," "regulated" or "deregulated," should be included in the realized rate of return calculation.
- All earnings in excess of 50 basis points over the ILEC's authorized rate of return should be refunded to ratepayers as a sharing credit.
- The ILEC's authorized rate of return should be set on the basis of its virtually riskless earnings stream.

Alternatively, if the ILEC wants the earnings flexibility of the present price cap regime, it should be required to treat the stranded investment "gap" the same way that firms in competitive markets would do: write-off the "gap" without specific recovery. Where an ILEC elects this option:

- It will be permitted to elect the no-sharing/no-earnings-limit price cap option.
- Rates for noncompetitive services will be set at TSLRIC.
- Rates for competitive services, as well as those for enhanced and nonregulated services furnished out of the common ILEC asset and organization resource base, will not be subject to regulation.

By offering ILECs a choice between assured investment recovery or unlimited earnings, the Fifth Amendment "takings" issue disappears. Since an ILEC will also have the option of electing to be made whole, it cannot claim confiscation if, for example, it voluntarily elects the unlimited earnings option and fails to adequately recover its costs and embedded investment. If an ILEC elects to forego assured investment recovery in exchange for earnings flexibility, it will shift the risks and the rewards from ratepayers to shareholders and, by its election, indicates its confidence that the present expected value of the earnings that it will have an opportunity to generate will more than exceed the dollar amount of any "stranded investment." Accordingly, at the time of such election, the ILEC will have been fully compensated and "made whole." From that point forward, the ILEC's

fortunes will be substantially in its own hands, and no further compensation or assured recovery will be required even if the firm fails to meet its earnings goals.

- e. The Commission must re-initialize rates and adjust the price caps rules to ensure economically efficient TSLRIC pricing for access services

The Commission has correctly recognized, at paragraph 223 and 248 of the NPRM, that steps will need to be taken to reconcile the existing price cap rate levels with the requirement that access charges be set at TSLRIC. Because the "going in" rates upon which the present price cap system is based were themselves driven by embedded costs (i.e., the ILEC's revenue requirement under RORR), subject to small incremental annual changes as dictated by the price caps formula, rates expressly set at TSLRIC will, in the aggregate, be lower than the prevailing price cap rates. Accordingly, the Commission proposes to reinitialize the Price Cap Index (PCI) to correspond with the TSLRIC rate levels. Alternatively, at paragraph 228, the Commission proposes to re-initialize rates to a level that would result in rates targeted to yield the currently prescribed rate of return or some newly prescribed rate.

In addition, the Commission must make three specific adjustments in its present price cap structure to conform it with the requirements of incremental cost pricing:

- The PCI must be reinitialized so that aggregate revenues allowed under price caps equate with the aggregation of revenues from individual services priced at TSLRIC.
- The authorized rate of return should be reduced to reflect (a) the lower market rates currently in effect (vis-a-vis those prevailing at the time that the 11.25% authorized ROR was set), and (b) the minimal level of risk associated with the ongoing provision of services that will continue to be subject to price cap regulation — i.e., those noncompetitive access services that would be prescriptively priced at TSLRIC. Services that do confront effective competition confront the ILECs with a more variable — and hence riskier — earnings stream, but these services would be excluded from price cap regulation and be subject to market-based pricing under the Commission's tentative proposal.
- Substantially increase the X-factor as recommended by Ad Hoc and others in their comments to the *Fourth Further Notice* in CC Docket 94-1, to reflect the greater productivity growth and slower input price growth that the ILECs have been confronting in recent years and that they will continue to confront on a forward-looking, incremental cost basis.

Each of these changes is a critical element of access charge reform, and is inseparable from the specific rate reductions and restructuring that will be dictated by forward-looking incremental costs and cost relationships. Rates must be reduced to TSLRIC levels, and on an ongoing basis rates should continue to accurately reflect the then-extant TSLRIC. The use of historical productivity growth experience in setting the X-factor is equivalent to, and suffers from the same infirmities as, the use of historic embedded costs in setting rates for individual services. Price caps, like the individual service rates themselves, must be redefined and reinitialized to accurately capture and reflect costs and cost changes on a forward-looking basis.

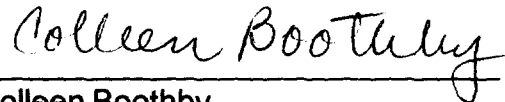
CONCLUSION

For the reasons set forth above, the Ad Hoc Committee supports the Commission's efforts to reform the current Part 69 rate structure and to move access charges closer to economically efficient levels.

Respectfully submitted,

The Ad Hoc Telecommunications
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